

Development Finance Institutions

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Summary

Few development finance institutions (DFIs) have achieved sustainability. Fewer still have had any noticeable effect on strengthening financial markets. Although DFIs have helped expand the supply of credit to the private sector, they have not been particularly successful in reaching their target beneficiaries: small businesses and farmers. Consequently, USAID should avoid DFIs as instruments for financial market development and rely instead on financial market reform and established financial institutions to strengthen these markets. Where the only choice is support to a DFI, USAID should encourage the institution to charge real interest rates and to lower administrative costs.

Background

After decades of support to DFIs with results often contradicting donor expectations, many donor agencies found themselves at a critical juncture. On the one hand, the 1989 DAC agenda report recommended continued support for these institutions. On the other hand, donor experience suggested that these institutions have been unable to achieve their objectives. To stimulate discussion on the issue of continued support to DFIs, CDIE prepared a synthesis report of donor experience for the Organization for Economic Cooperation and Development's Development Assistance Committee (OECD/DAC). The report, presented at the February 1989 meeting of the DAC Expert Group on Evaluation, is based on a review of donor evaluations covering projects from the mid-1970s to the late 1980s. Specifically, the paper draws on evaluation reports from nine donors: the Asian Development Bank, USAID, the Canadian International Development Agency, the Danish International Development Assistance Agency, the German Federal Ministry for Economic Co-operation, the Inter-American Development Bank, the Royal Norwegian Development Bank, the Swedish International Development Assistance Agency, and the World Bank.

Findings

- ! **Target beneficiaries not reached.** DFI programs in some developing countries have helped expand the supply of short- and long-term credit to the private sector, but they have not been successful in reaching small- and medium-size enterprises. High collateral requirements of credit,

significant transaction costs of loans, and high interest rates charged to subborrowers have typically resulted in tremendous concentration of resources in the hands of a few large subborrowing enterprises located in particular areas. Moreover, the review points to the informal sector's continued inability to access formal sources of credit, including loans from DFIs.

- ! **Financial markets not strengthened.** DFIs have been unable to contribute to strengthening financial markets in developing countries. The assumption of donors that DFIs would have a virtual monopoly over long-term financial markets in developing countries has proven false in face of increasing competition from commercial banks, leasing companies, and other sources of long-term credit. Furthermore, financial policy measures in many developing countries control interest rates and credit allocations, limit short-term lending and commercial paper operations, restrict competition among financial intermediaries, and constrain financial diversification. These measures place severe limits on the ability of DFIs to offer new financial services, raise substantial domestic resources, and help develop domestic capital markets.
- ! **DFIs not sustainable.** Contrary to expectations, most DFIs have been unable to achieve sustainability. Poor financial performance is typical of the majority of donor-supported DFIs, prompted by poor financial management, lack of risk diversification, high arrears on loan portfolios, and conflicting donor objectives. Most DFIs have been unable to mobilize domestic savings and to operate as full-fledged financial institutions—factors important for sustainability—as well as for diversification of risk and successful competition with other institutions offering long-term credit. Furthermore, the cost associated with providing a wide range of services aimed at reaching development objectives has added to the financial burden of these institutions.
- ! **Donor agendas conflict.** Donors have often operated at cross purposes. Two different objectives leading to two different orientations have characterized DFIs during the past two decades. Some donors have viewed DFIs as vehicles for promoting development objectives, whereas others expected DFIs to be self-sustaining financial intermediaries. These two objectives have often worked at cross-purposes leading to the question: When does financial self-sufficiency become the overriding objective to the exclusion of development aims? Adding to the problem, donors have supported a multiplicity of DFIs targeting a range of economic sectors and establishing different interest rates and loan criteria for subborrowers in the DFIs assisted. The result has been confusion among beneficiaries, underutilization of donor funds, and instability of the lending institutions.

Recommendations

- ! **Avoid using DFIs**, particularly as instruments for strengthening financial markets.
- ! **Focus instead on financial market policy reform**, which is more critical to developing strong financial markets.

In cases where support of a DFI is the only option:

- ! **Consider the economic and financial framework** in which a DFI must operate before deciding to assist the institution.
- ! **Encourage DFIs to charge real interest rates** and rely more on well-established commercial financial institutions with extensive branch networks.
- ! **Assist DFIs to diversify their operations and encourage competition** among DFIs and similar financial intermediaries. One such approach has been to have an umbrella loan available to more than one DFI and one or more non-DFI intermediaries, such as commercial banks.
- ! **Assist DFIs to improve their financial management** so they can cope with a competitive economic environment.
- ! **Assist DFIs in lowering the administrative cost of their loans.**
- ! **Decide on the orientation of the DFI:** Is the DFI expected to function as a self-sustaining financial institution, even if some of its development goals must be foregone as a result, or is the DFI expected to function predominantly as a subsidized vehicle for development?
- ! **Encourage other donors to join in adopting a more coordinated response** to promoting the development of financial markets and DFI programs. In this context, encourage greater collaboration among donors in setting the terms for lending to DFIs, the rate of interest charged to subborrowers, and the eligibility criteria for these programs.